OFFICE OF THE MISSOURI STATE TREASURER
SARAH STEELMAN, TREASURER

Date: September 16, 2008

To: Board Members of the Missouri Higher Education Savings Program

From: Mark Mathers
Director of Investments, Missouri State Treasurer's Office

RE: 2007 ANNUAL PROGRAM REVIEW

Section 166.450 of the Revised Statutes of Missouri (RSMo) requires an annual review of the Missouri Higher Education Savings Program (or "MOST") by the director of investments of the state treasurer's office and the reporting of findings to the MOST Board. The statute requires a review of five areas:

- Board administration
- Financial status
- Investment policy
- Participation rate
- Continued viability

Therefore, in accordance with these requirements, I am pleased to present the following findings from my review for calendar year 2007. When possible, I have attempted to use comparative data on other states' plans available from the College Savings Plan Network (CSPN) to supplement my analysis of Upromise's quarterly reports. I am available to discuss these findings at your convenience.

I. Board Administration

Upromise Investments Inc., a division of Upromise, Inc. assumed responsibility as program manager for the MOST Plan on June 3, 2006. Therefore, 2007 represented the first full year for the Upromise team. The Board and the State Treasurer's Office worked closely with Upromise and monitored their management of the program. The Board met quarterly during 2007, as required by law.

II. Financial Status

In this section of the report, we review the financial status of our major partners and summarize the investment performance of the most popular investment options within the MOST Plan.

A. Financial Status of MOST Partners

During the second half of the year, we witnessed the beginning of the U.S. credit and subprime mortgage crises, which to date has led to more than $500 billion in writedowns on financial institutions' balance sheets and the demise of the country's fifth largest investment bank, Bear Stearns. As a result, many financial institutions have struggled to remain profitable. That fact reinforces the need to review the financial status of our major partners and counterparties.

As a result of reductions to the federal government's subsidies to student lenders and dislocations in the student loan industry, SLM Corporation, the parent company of Upromise, saw its long-term ratings from Moody's, Standard & Poor's and Fitch downgraded in 2007 and early 2008 from an "A" level to "BBB" (near or at the lowest investment grade). SLM's credit rating is less of an issue for the MOST plan because none of the investments of the new MOST plan are secured by SLM; however, a further downgrade to SLM Corporation's rating to junk-bond status would be an indicator that there continues to be concerns regarding the company's profitability. In 2007, a consortium of hedge funds and banks that had made a formal offer to buy out SLM abandoned the transaction in the wake of the federal reductions and increasing financing costs. As part of the settlement between SLM and the group, JP Morgan and Bank of America agreed to provide a $30 billion line of credit to SLM, which has since been extended.

The two investment managers for the Direct Plan, The Vanguard Group and American Century Companies Inc., remain strong franchises. Although neither company is publicly traded and thus do not publish financial statements we can examine, our research of their funds indicates that both companies managed to avoid issues related to subprime mortgages or SIV's that other mutual fund firms had to face in 2007. Vanguard held onto its position as the second-largest U.S. mutual fund firm with $1.28 trillion in assets under management, or slightly more than 10% of the total mutual fund market. Vanguard saw net inflows of $76.2 billion in 2007, which was the most among all asset managers. American Century saw outflows of $10 billion in 2007. The table above summarizes assets under management as of year-end for each firm.

Assets under Management (in billions)

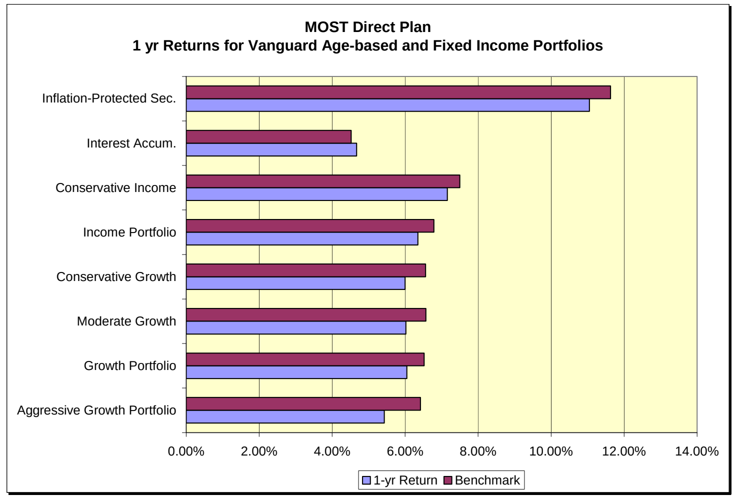
Year	Vanguard	Am Cty
2003	$690	$87
2004	$814	$98
2005	$921	$101
2006	$1,107	$103
2007	$1,280	$102

In terms of the credit risk of underlying investments in the Direct Plan, the Vanguard Interest Accumulation Fund invests in non-collateralized guaranteed investment contracts (GIC's) with insurance companies and banks but Vanguard requires a "AA" rating for such entities. The TIAA-CREF Guaranteed Option is invested in funding agreements with TIAA Life Insurance Company, which remains AAA-rated.

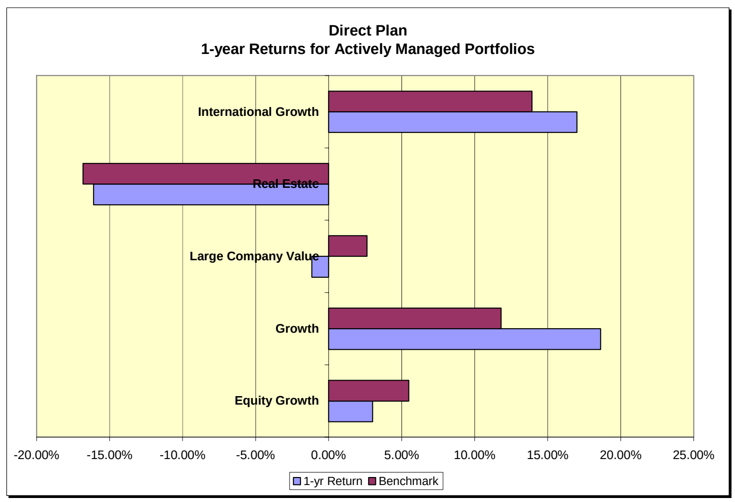
B. Performance of MOST Underlying Funds

The MOST Direct Plan offers participants a wide range of investment choices including three different tracks of age-based options composed of Vanguard index funds, three different 100% Equity Options and five stand-alone American Century actively managed funds. For participants of the MOST program who select either the age-based options, Vanguard allocates contributions among a combination of Vanguard mutual funds. The allocation guidelines for the three age-based tracks are set using certain age bands, which are based on the beneficiary's year of birth. As beneficiaries age, they move from one age band to the next. The allocations among Vanguard mutual funds are different for each age band – the younger the beneficiary, the more contributions are weighted towards equities. As beneficiaries age, an increasing percentage of funds are allocated to bond and money-market investments.

Because the three age-based tracks (Conservative, Moderate and Aggressive) are composed entirely of index funds, their performance should track that of their composite benchmarks and would be expected to rise and fall over time in line with the broad market indices they are intended to mirror. In 2007, this was the case as the age-based and fixed income Vanguard funds had very minimal tracking error. As a result, the portfolios within the age-based options showed total returns for 2007 of 5.43% to 7.16%. The MOST Blended Stock Portfolio and Vanguard 100% Stock Portfolio showed similar results.



The five stand-alone equity funds offered in the Direct Plan are managed by American Century Companies and are offered to allow participants to either customize a portfolio of their own or supplement their investments in the age-based or 100% Equity Option portfolios. Since these funds are actively managed, their performance will likely vary from their benchmark, with the obvious intent being to outperform their benchmark. In 2007, the five American Century funds' performance was mixed as the International Growth and American Century Growth portfolios strongly outperformed their benchmark index by 3.08% and 6.82% respectively. In a difficult year, the Large Company Value and Equity Growth portfolios underperformed their large-cap benchmarks.



In the Advisor Plan, a lineup of stand-alone funds are offered to brokers, who then customize portfolios for their clients based on clients' cash flow needs and risk tolerances. These funds are offered from multiple fund families and in different styles and capitalizations. The Board approved a number of significant changes to the Advisor Plan lineup in mid-2007 to lower overall costs for the program and address style-cap gaps in the 2006 lineup. A detailed review of underlying funds' 1- and 3-year performance is found in the quarterly reports provided by Upromise to the Board and in the new quarterly performance monitoring reports begun in 2008.

III. Investment Policy

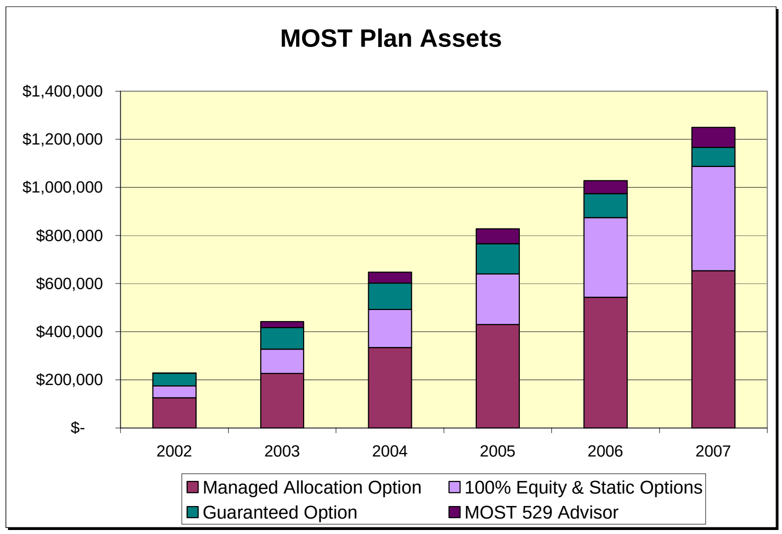
The Missouri Higher Education Savings Program adopted a formal investment policy governing its investments in June 2007. The policy establishes objectives for the structuring the investment options in the Direct and Advisor Plan, formulates policies for selecting appropriate investment managers and the use of specific investment vehicles, and establishes an investment performance process for underlying funds in the Plan. The plan is an important statement by the Board in terms of defining its fiduciary responsibilities and standards for State Treasurer staff and MOST partners.

Due to the substantial changes to the lineup for the Advisor Plan that were adopted mid-year and took effect in the fall of 2007, the separate reporting of funds' investment performance began in the first quarter of 2008.

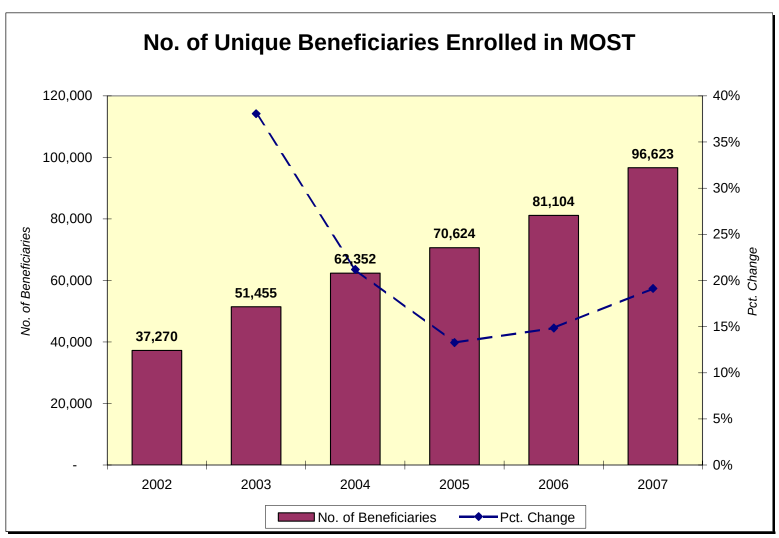
IV. Participation Rate

In this section, we examine the participation rate of the MOST program. By examining the participation rate for the program, one can attempt to gauge the relative success that the state's program has had in reaching the state's residents and encouraging them to increase college savings—the original goal of the IRS section authorizing these programs. The relative success or failure of states' various 529 programs rests on many different factors including the effectiveness of marketing efforts, demographic and economic conditions, cost structure and the abilities and resources of states' partners to attract and retain assets. However, one facet that has remained a constant is the competition for assets among states' program managers. As the field of firms in the 529 industry has shrunk, this competition for assets remains fierce as evidenced by the decline in fees among plans issuing new RFP's in the last 18 months.

A. Growth of Plan in 2007



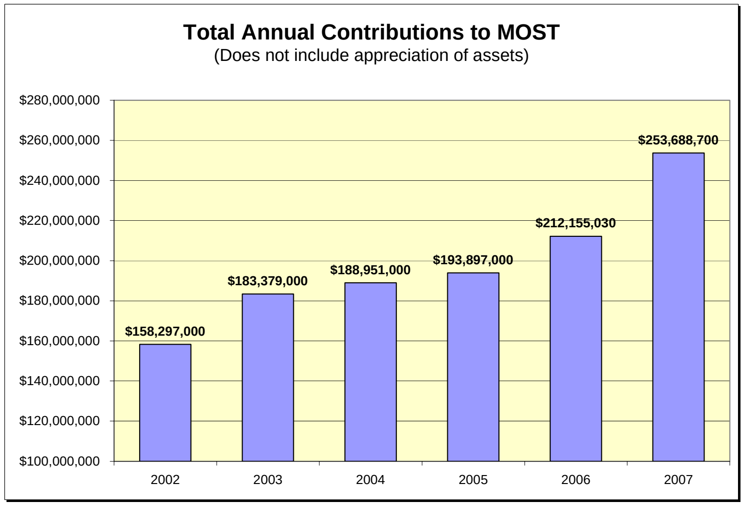
Overall, MOST has shown steady growth, on generally the same trajectory as the 529 industry as a whole, since its launch in late 1999. This growth is attributable to both the appreciation of assets in the plan and the contributions of new and existing account owners. MOST ended 2007 with $1.25 billion in assets compared to $1.03 billion in 2006. Within the Direct Plan, age-based options remain the single most popular type of investment option holding steady at 55-56% of Direct Plan assets. Funds continue to flow out of the Guaranteed Option. Assets in the Advisor Plan saw the greatest growth rate, increasing 54% from $54 million to $83 million. Overall, assets in MOST increased 22%, which is in line with the 23% growth rate for all 529 plans in 2007.



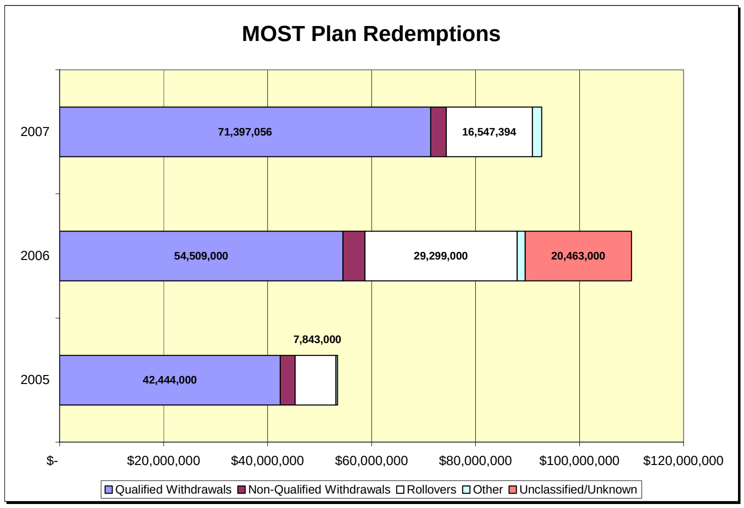
While a review of the assets in the MOST plan is informative, it is difficult to separate the effect of the capital appreciation of assets versus the actual growth of participants. A useful measure of participation in a plan is the number of beneficiaries enrolled in the plan. Since 2003, we had seen steady growth of 8,000 to 12,000 new beneficiaries per year. However, in 2007, the number of new beneficiaries enrolled increased more than 15,000. This represented an

increase of 19%, the highest percentage increase in assets since 2004.

Contributions by existing and new account owners also showed strong growth in 2007. Contributions totaled more than $250 million last year, which is considerably higher than the period from 2003 through 2006 where MOST contributions seemed to have reached a plateau of around $200 million. In last year's report, we had remarked on the accelerated pace of contributions in the second half of the year after Upromise assumed management of the plan. This trends continued in 2007, their first full year of operation.

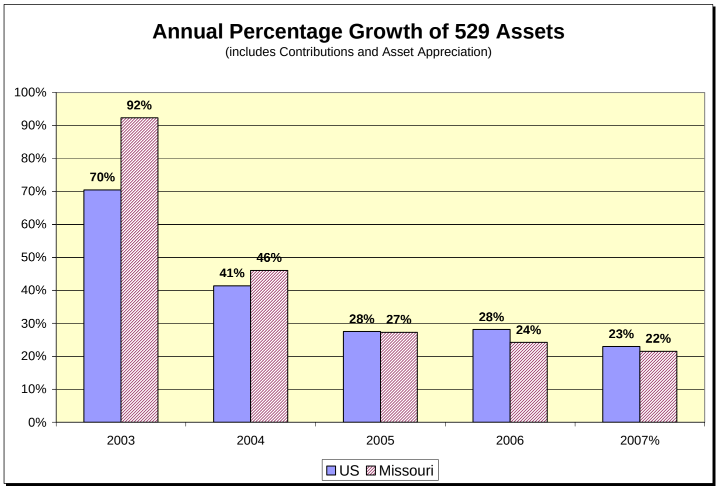


B. Redemptions

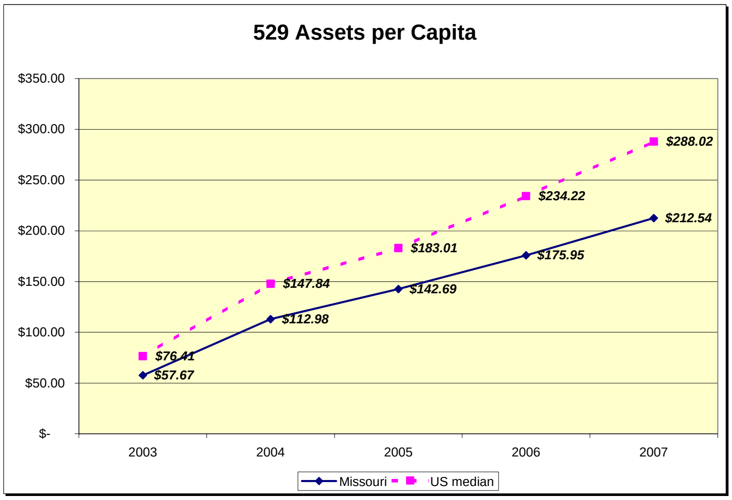


With the strong growth in contributions in 2007, which includes flows from both existing account owners and new accounts, we would have expected a greater jump in overall assets in the plan in 2007. However, we also have seen an increase in the total redemptions, or withdrawals, from the plan. Redemptions have basically doubled from $53.5 million in 2005 to more than $110 million in 2006 and $93 million in 2007. The chart below breaks out redemptions into three main categories: (1) qualified withdrawals which are used by account owners to cover tuition and other qualified expenses, (2) non-qualified withdrawals which might be used for ineligible expenses, for example, or might simply represent withdrawals from the plan in the event of a beneficiary choosing not to pursue higher education, and (3) rollovers out of MOST into other 529 plans. In 2007, the vast majority of redemptions ($71 million) were used for qualified college expenses. However, $16.5 million represented rollovers out of the plan, which is a relatively high figure for MOST and virtually double the amount of rollovers prior to 2006.

C. Comparison of MOST Participation to National Trends



Another method of analyzing participation in the MO$T program is to make a comparison of Missouri to our peers, namely other states. Appendix A provides data for each state's 529 assets. In this table, we compared two separate measures of participation: (1) 529 assets per capita and (2) the penetration rate. The penetration rate is defined here as the ratio of total 529 Plan accounts to the total number of households in the state. Because of the many differences in states' programs, demographics and geography, the purpose of this review was not to make individual comparisons of state's programs. Several states, such as Virginia and Maine, attract a much greater percentage of out-of-state monies because of the fee structure provided to the investment advisors marketing these programs. Investment advisors in non-resident states may advise placing their clients in these states' 529 programs due to the financial incentives provided. As noted previously, though, the growth rate for MOST assets in 2007 essentially tracked national trends. As the chart on the right shows, this has been the case for a number of years, with 2006 being the exception.



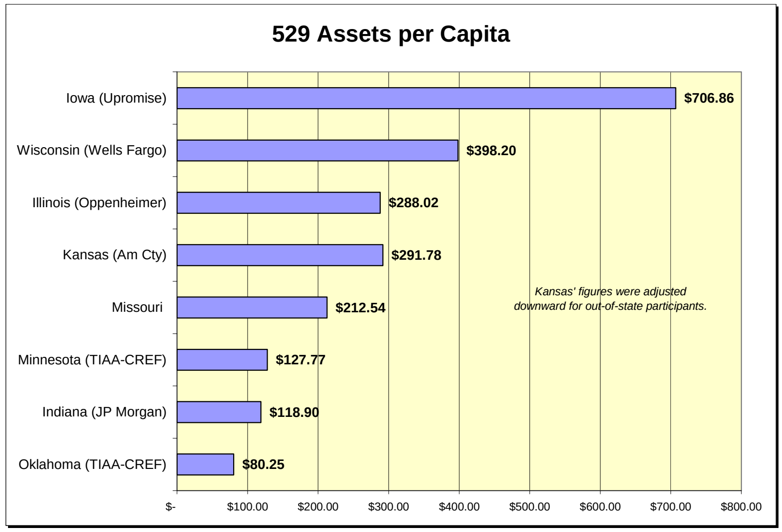
The following chart provides another measure against national statistics, this time comparing MOST assets on a per-capita basis (MOST assets divided by Missouri's population) to total 529 assets per capita. We have seen the gulf in this measure widen somewhat over time. This is due to a slower growth rate for the MOST plan than the national rate (see above) as well as greater penetration among households by other state plans. In terms of 529 assets per capita, Missouri now ranks 31st with $212.54 in 529 assets per capita. This compares to the national average of $430.80 and the median of $288.02.

In terms of the penetration rate, Missouri also ranks 31st among states, with an estimated 4% of Missouri households having a MOST account. This compares to the median nationally of 5.7%. One factor for the lower participation in Missouri is that family income in Missouri is slightly less than the national average.

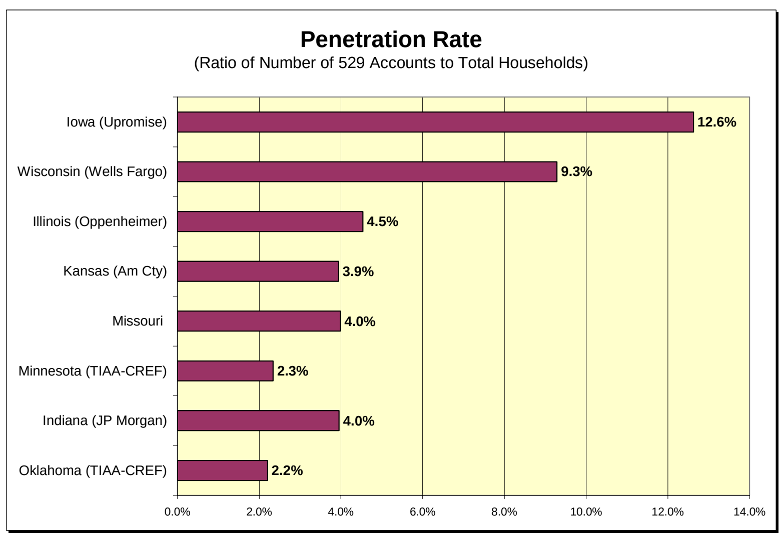
D. Comparison to Peer States

For several years, the annual report on MOST has compared the MOST program to a peer group of other Midwestern states. This year's report updates these statistics.

The chart on the right once again compares 529 assets per capita. Missouri ranks near the middle of this peer group. The average per-capita 529 assets of this peer group is $261 per person. We would note that in Iowa, Wisconsin and Kansas, those states have had long-standing relationships with their respective program managers. Additionally, in contrast to MOST, in both Wisconsin and Kansas their asset managers -- Wells Fargo and American Century respectively – do not sell any other direct plans. As a result, undoubtedly these two plans have attracted a sizeable number of out-of-state clients. The same dynamic holds true for Kansas' relationship with Schwab, which manages the Schwab 529 College Savings Plan. While we adjusted Kansas' figures by 60% to reflect out-of-state accounts, we did not do the same for Iowa or Wisconsin due to the lack of data from those states. We suspect, though, that there may be significant non-resident participation in Iowa and Wisconsin as well, thereby somewhat inflating those states' numbers.



In terms of its penetration rate, Missouri ranks near the middle of this peer group although once again well below Iowa, Illinois, Kansas and Wisconsin. The average penetration rate for this peer group is 5.1%, compared to Missouri's rate of 4.0%. Kansas' estimated penetration rate after discounting 60% of accounts as out-of-state is 3.9%.



V. Continued Viability

The MOST program remains a viable, well-respected college savings program. In Upromise's first full year of operation, we saw strong growth in contributions to the plan, which rose from a range of $180-195 million during TIAA-CREF's last three full years of operations to $253.7 million under Upromise in 2007. We also saw an upswing in the number of new beneficiaries enrolled in the plan, which shows growth of new customers, and much better participation in the Advisor Plan among Missouri-based brokers. All of these measures indicate solid growth for MOST last year. We also believe that the comprehensive changes to the Advisor Plan that the Board approved in 2007 to reduce costs and expand investment options has helped make this plan a significantly stronger offering to financial advisors and brokers than the pre-2006 Advisor Plan.

At the same time, competition among the states and their program managers for 529 assets remains fierce. In past years' reports, we have estimated that the amount of Missourians' assets that are held in other state plans may be as much or even more than that held in MOST. With the signing of SB 863 in 2008, which extends the state tax deduction now to all 529 plans, MOST no longer enjoys a state tax advantage over other plans and must continue to provide good, low-cost investment options for residents to thrive.

In last year's report we also noted several items that we felt would favorably position MOST in the future. These included the development of the MOST CD plan and the introduction of the Upromise and MOST brands to St. Louis area grocery stores. To date, for different reasons, these projects have not progressed. In 2008-2009, though, these two concepts still provide an opportunity for greater penetration and participation in the MOST program.